Implications of Income Inequality for Social Security's Contribution and Benefit Base

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Introduction

- Today we have discussed range of secular trends and their implications for Social Security benefits
  - Increasing and disparate longevity
  - More employed women and single-parent families
  - Changes in the labor market
- Slow and unequal wage growth is another key trend
- Poses two problems for Social Security:
  - hurts system finances
  - will lead to greater levels of retirement income inadequacy than would be the case with shared growth
- What are implications of slow and unequal wage growth for Social Security revenue design?

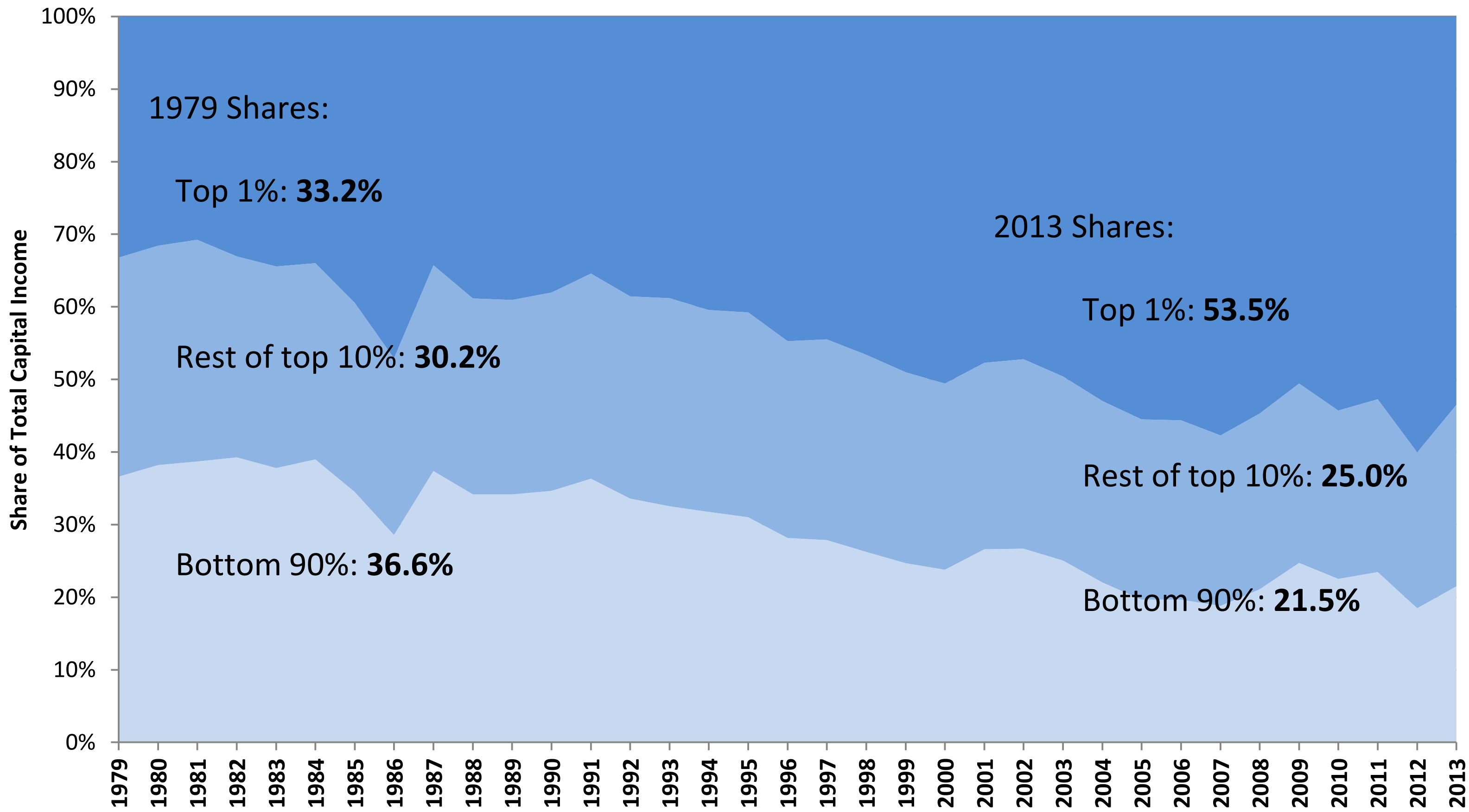
Social Security was part of mid-20th century social contract

- Response to stark inequalities in period leading up to the Great Depression and insecurities that followed
- Mid-century social contract included other elements
  - minwage, collective bargaining, UI, AFDC, massive public investments in ed/housing/infrastructure, high income & estate tax rates, strong regulation of financial markets
- Virtuous cycle of shared prosperity: firms pay workers sufficient wages to consume goods produced, spurring economic growth
- From 1947 through late 1970s, rising tide raised virtually all boats – strong, shared growth
- Social Security was expanded multiple times during

Since 1979: slow, unequal wage growth

- Range of economic drivers:
  - Intensified cross-border exchange and competition from 1980s on led to lower wages and outsourcing
  - Technological innovation and information technology revolution
- Political choices reinforced income inequality:
  - Erosion of labor law protections of right to organize and bargain collectively contributed to decline in union density
  - Free trade agreements subjected low-wage workers to low-wage competition from developing countries
  - Deregulation of financial sector fostered capital mobility; ROI in financial sector often exceeded that in ‘real’ economy
  - Failure to maintain real value of federal minwage since peak in 1968
- Taken together, led to asymmetric capital-labor power relations
- Corporations gained leverage vis-à-vis workers and used it to direct larger share of income to owners of capital and high-level managerial employees
- Modest decline in labor share of national income
- Tremendous growth in inequality *within* labor income

Share of income from capital accruing to top 1% has risen steadily



Source: Congressional Budget Office, 2016, *The Distribution of Household Income and Federal Taxes, 2013,* based on a method developed in Lawrence Mishel, Josh Bivens, Elise Gould, and Heidi Shierholz, *The State of Working America, 12th Edition*, The Economic Policy Institute.

Impact of slow and unequal wage growth on Social Security's finances

- Social Security contributions are due only on first $127,200 in earned income
  - Only bottom 94% of earners pay contributions on all their earned income
- Investment income is not subject to Social Security contributions
- Higher earners pay contributions on neither earnings above cap nor investment income
- Slow, unequal wage growth thus hurts Social Security's finances
- Income inequality has also contributed to differential longevity, which also hurts system finances

Social Security needs revenue base that grows with the economy

- Benefits are indexed to growth in *average* wages in the economy
- When earnings above cap grow faster than those below, initial benefits grow faster than revenue flowing into system
- In 1977 Amendments, Congress took explicit measures to ensure taxable payroll – share of covered earnings subject to contributions – would reach 90% by 1983
- Primarily because most earnings growth since then above cap, Social Security's tax base has shrunk from over 90% of covered earnings in 1983 to low 80s today

Policy options

- Stimulate wage growth in middle and lower end of wage distribution, shared prosperity
- Lower health-care costs to leave middle and lower income workers with larger share of total compensation as wages taxable for Social Security
- Eliminate tax cap on earned income so that Social Security tax base captures growth in earnings above current cap
- Incorporate investment above certain threshold into Social Security
- In both of the above cases, maintaining principle of earnings-related benefits is key social insurance principle
- Restore estate tax to e.g. 2000 level and dedicate to Social Security

What could a Social Security NIIT look like?

- ACA set precedent of subjecting investment income to social insurance contributions with Medicare NIIT (although does not go into HI Trust Fund)
- Since 2013, it levies 3.8% tax on net investment income of those with MAGI above $200k ($250k for couples)
  - Net investment income includes interest, dividends, capital gains, nonqualified annuities, royalties and rents, and passive income from businesses, incl. those trading financial instruments or commodities
- For Social Security, design would be more complicated than NIIT, because contributions would have to be credited to individuals
- Same household MAGI threshold could be used, to avoid higher-income partner shifting investments into spouse's name
- But investment income must be attributed to an individual, or shared and split equally, in order to inform Social Security benefit calculation
- If earnings tax cap were eliminated, unless investment income were also taxed, 6.2% tax on earnings above cap would provide even stronger incentive for high earners to shelter earnings by shifting them into investments (to pay more favorable capital gains tax rate)

Design issues in crediting contributions toward benefits

- There is no employer matching contribution on investment income (hence a 6.2% Social Security NIIT would be half the 12.4% FICA rate on earned income)
- Hence half of net investment income could be incorporated into an individual's income record (AIME) for Social Security benefit (PIA) calculation
- In conjunction with eliminating earnings tax cap, policymakers would need to decide whether to use 15% PIA factor or some lower factor – or declining series of factors – in crediting contributions on higher (earned and investment) income toward benefits

Conclusion

- The economy and the distribution of gains of economic growth have changed radically over the past four decades – exacerbating income inequality and leading to greater levels of retirement income inadequacy than would be the case with shared growth
- Social Security policy should respond to these changes
- Incorporating investment income into Social Security's contribution and benefit base is one of many policy options for doing so, and it could be designed in a variety of ways
- It would bring Social Security revenue growth in better sync with growth in economy, and mitigate inequality
- If the ACA's NIIT is repealed, a Social Security NIIT would become more likely